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Top 10 Best Practices For Lenders On Problem Loans

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Law360, New York (April 6, 2010) -- Since the start of the financial crisis, the number of problem loans has increased as real estate values declined, credit markets tightened and various companies struggled to survive and stay in business during this recession.

For lenders who made loans secured by real estate or personal property collateral during better economic conditions, these lenders are now being faced with loan defaults and having to decide whether to workout the loan (e.g., by giving an extension of maturity date, or restructuring the interest rate or other loan terms, or waiving certain defaults) or to exercise its rights and remedies (e.g., by foreclosure, appointment of a receiver, action against the guarantor, etc.).

The following identifies 10 best practices and issues for consideration by lenders when dealing with a problem loan.

Top Ten Tips for Lenders

1. Centralize lines of communication.

To avoid the "end-run" around asset management, the lender should speak with "one voice." Whether the lender representative is an officer in the special assets department or an asset manager responsible for the loan, the lender should avoid assurances to the borrower that a workout will be possible. At the early stages, the lender may be unaware of facts that will make a consensual workout impractical. At the same time, the lender will want to assemble its team comprised of the asset manager, counsel, appraisers and other outside experts.

2. Review your collateral.

The lender will want to update its evaluation of repayment sources, including available collateral for the loan. In evaluating the value of collateral, the lender should consider the following, as may be applicable: (a) appraisal, (b) updated title report and UCC searches, (c) environmental review, (d) development status of the project (e.g., entitlements, construction, obligations to contractors), (e) engineering review, and (f) confirm that required insurance coverages are in place.

3. Review your loan documents.

After identifying a problem loan, one of the first steps for the lender is to retain counsel to prepare a document review report identifying any problems with the loan documents and determining whether there are any major issues with the loan documents that would make the exercise of remedies problematic. For example, for a California real estate secured loan, if the deed of trust is missing the customary "power of sale" language, then the lender may not have the option to pursue a nonjudicial foreclosure sale of the real property collateral. In such case, the lender may be limited to a judicial foreclosure sale, which is generally more time-intensive and costly, unless the lender enters into a consensual loan workout to cure this deficiency in the loan documents.

4. Check for suretyship waivers.

Depending on the applicable governing law, a guarantor of a loan may be entitled to numerous statutory and judge-made rights and defenses, which may undermine the purpose of the guaranty unless such rights and defenses are effectively waived. Guaranties typically include suretyship waivers. However, such waivers are often missing in other loan documents when the loan involves co-borrowers or third-party pledgors of collateral. Suretyship rights and defenses also may arise indirectly if one loan is cross-defaulted and cross-collateralized with another loan, and the loans are made to distinct entities. As part of its document review, the lender's counsel should carefully review the inclusion and adequacy of suretyship waivers in the loan documents.

5. Correct any deficiencies in UCC-1 financing statements.

A common mistake on a UCC-1 financing statement is wrong debtor name! The lender should verify the formal legal name of the borrower. If the borrower is an entity, the UCC-1 should have the name shown on the Articles of Incorporation, Certificate of Formation, or Certificate of Partnership, as may be applicable, on file with the appropriate filing office designated by the state of the borrower's organization. For example, if the name of a corporation organized in California is "ABC Corporation," the UCC-1 should not state the name of the debtor as "ABC Corporation, a California corporation." Depending on the search parameters of the filing office, a UCC search of a debtor by its correct legal name may not turn up financing statements with mistakes in the debtor's name. Moreover, the lender should always obtain a certified post-filing UCC search to confirm that its UCC-1 financing statement is shown on record.

6. Review the administration of the loan.

The asset manager handling the problem loan should confer with any relationship manager or prior asset managers to flush out potential lender liability claims. For example, is

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there any evidence of oral agreements modifying the written loan documents, or course of conduct that may suggest implied waiver of the terms of the written loan documents? Any complaints by the borrower that the lender has not performed? Any evidence of inappropriate conduct such as inordinate involvement in management?

7. Review your borrower and guarantors.

The lender also may want to update its review of the borrower and any guarantors of the loan, including taking one or more of the following steps: (a) obtain current financial information on the borrower and guarantors, (b) evaluate the current management (i.e., competence, motivation, honesty, and intentions), (c) evaluate current operations (i.e., financial controls and position in market), (d) evaluate external factors (i.e., general economic conditions, market conditions for particular product type, etc.), (e) identify the causes of the borrower's problems (Extraordinary event or ongoing issues? Fundamental problem in the market or borrower's business plan? Is borrower diverting rents or other income?), and (f) determine if borrower has sources if additional cash is needed.

8. Determine your strategic position.

The lender should identify defaults and potential defaults under the loan documents, checking notice and/or cure requirements and possible waiver issues. Then, the lender should evaluate the materiality of the defaults. Is there a material breach of a material obligation? Evidence of a material deterioration in the borrower's financial condition, in the value of collateral, and in prospects for repayment? Once the lender has determined that one or more material defaults exist under the loan, the lender can consider its available rights and remedies under the loan documents and applicable law (e.g., demand the curing of defaults, cease funding, impose default rates of interest, accelerate principal balance, etc.) and determine if any documentation or collateral deficiencies might impair the lender's ability to take any specific action. Finally, the lender should consider the likely reaction of the borrower and its other creditors to any action to be taken (e.g., bankruptcy of the borrower).

9. Select a strategy.

Subject to the loan structure and any documentation or collateral limitations, the lender may have various options in dealing with a problem loan, such as the following:

(a) Do nothing.

(b) Gather more information.

(c) Grant a temporary or permanent waiver of default.

(d) Extend time to cure defaults.

(e) Encourage the borrower to address its problems, including getting advice from consultants. (To avoid potential lender liability, the lender may offer suggested consultants, but the lender should not mandate any particular consultant or make the borrower's selection subject to lender's approval.)

(f) Restructure the terms of the loan (i.e., commence a workout).

(g) Accelerate the loan and demand payment.

(h) Request a deed-in-lieu of foreclosure.

(i) Commence nonjudicial foreclosure sale.

(j) Exercise judicial rights and remedies, including nonjudicial and/or judicial foreclosure, appointment of a receiver, and action against any guarantors.

10. Consider a prenegotiation agreement.

If the lender is considering a consensual workout, the lender should consider entering into a prenegotiation agreement with the borrower, the guarantors or joinder parties, and any third-party pledgors or indemnitors before starting negotiations. The basic elements of the prenegotiation agreement are to clarify among the parties that there is no deal until it is in the final documents, that there are no oral agreements, that discussions will not be discoverable, and that the parties are not foregoing alternatives.

The lender may want to strengthen the prenegotiation agreement in its favor if the borrower has made threats or if the lender's negotiating position will allow (e.g., acknowledge loan is in default; no defenses to payment, etc.) However, the lender should beware of getting bogged down in negotiating the prenegotiation agreement, since the primary purpose is to ensure that neither party gives up any rights or incurs any obligations during the discussions unless a final written agreement is signed by the parties.

Conclusion

The handling of a problem loan presents pitfalls for the unwary lender. A lender should review the issues described above before rushing to workout a problem loan or exercise its remedies. A careful review of the loan documents and collateral may often reveal deficiencies that may be corrected easily prior to any action on the loan, and may shape the lender's approach to dealing with the problem loan.

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Sheppard Mullin Richter & Hampton covers this and other topics in the firm's Bankruptcy and Restructuring blog (www.bankruptcylawblog.com).

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